Community Development Financial Institutions Fund
Bank Enterprise Award Program
Policy Guidance on Equity-Like Loans
(Issued January 31, 2001)

The purpose of this document is to clarify the policy of the Community Development Financial Institutions Fund (the "Fund") in defining Equity-Like Loans for purposes of calculating Bank Enterprise Award ("BEA") Program grants and determining priority among Qualified Activities in the selection process. Capitalized terms not defined in this document are defined in the applicable BEA Program Notice of Funds Availability, the BEA Program Regulations, and the Glossary to the BEA Program Initial Application.

Background:

The Fund makes BEA Program awards to banks and thrifts that, among other activities, invest in communities with certain poverty and unemployment characteristics (see the BEA Program Regulations at 12 C.F.R. 1806.101). In addition, applicants making Equity Investments in CDFIs may be eligible to receive a BEA Program award. The BEA Program Regulations at 12 C.F.R. 1806.103(t) define an Equity Investment as:

> "financial assistance provided by an Applicant or its Subsidiary to a CDFI in the form of a grant, stock purchase, a purchase of a partnership interest, a purchase of a limited liability company membership interest, *a loan made on such terms that it has characteristics of equity (as is considered such by the Fund and is consistent with requirements of the Applicant's Appropriate Federal Banking Agency)*, or any other investment deemed to be an Equity Investment by the Fund." (Emphasis added.)

Accordingly, the Fund considers certain loans, "made on such terms that they have characteristics of equity," to be Equity Investments. The Fund refers to such loans as Equity-Like Loans. **The Equity-Like Loan as defined for the purpose of calculating BEA Program awards is not synonymous with the Equity Equivalent (EQ2) definition used by bank regulators under the Community Reinvestment Act (CRA).**

In general guidance issued by the Fund to Applicants as part of previous BEA Program funding rounds, the Fund stated that an Equity-Like Loan must meet *all three* of the following criteria: (1) the loan must have a "soft," flexible maturity (i.e., a rolling maturity such as when the maturity date is extended annually by one year, or a maturity in which repayment is required only when the CDFI borrower has resources available to make the payment); (2) payment of interest and/or principal may only be made out of the CDFI borrower's available cash flow and non-payment of principal or interest will not automatically trigger a default; and (3) the loan must be subordinate to all other debt of the CDFI borrower.

In recent years, as BEA Program Applicants have developed new loan and investment instruments, and the making of Equity-Like Loans has become more common in the financial services industry, the Fund has decided to update and clarify its policy on the types of instruments it will consider to be Equity-Like Loans for the purpose of calculating BEA Program awards.

The Fund's Policy:

Characteristics of Equity-Like Loans:

Until further notice, beginning with transactions carried out during its FY 2001 BEA Program funding round, the Fund will require an instrument to have ***each*** of the following characteristics in order to be considered an Equity-Like Loan:

(1) The initial term of the loan at the time of origination must be a minimum of ten years.
(2) The maturity date at the end of the initial ten year term must be a "soft" or indefinite, rolling maturity that is extended, subject to the following sentence, in no shorter than annual increments after the initial maturity date so long as the CDFI borrower continues to be financially sound and carry out a community development mission. The period of the extended rolling maturity must be a minimum of five years after the initial ten-year term. In other words, as long as the CDFI borrower remains fiscally sound and pursues a community development mission, the effective term of the loan must be at least 15 years.
(3) There shall be no periodic payments of principal during the initial term of the loan. However, the CDFI borrower may make periodic principal payments during the extended term of the loan or pay the entire loan off at maturity. Any payment shall be made in accordance with the provisions of this policy.
(4) Any payment of principal and/or interest on the loan (except at maturity) shall be required to be made only out of the CDFI borrower's available cash flow after satisfying all other obligations, including all non-equity-like debt and operating expenses. Furthermore, failure to make payment of principal and/or interest shall not automatically result in a default. However, nothing in the foregoing shall be construed as a requirement to forego any right to any payment of principal or interest.
(5) The loan must be subordinate to all other debt of the CDFI borrower except for other Equity-Like Loans.

Notwithstanding the foregoing, the Fund reserves the right to determine, on a case-by-case basis, if an instrument evidences an Equity-Like Loan.

Review Process:

Until further notice, beginning with the FY 2001 BEA Program funding round, the Fund requests that Applicants submit to the Fund for review, not later than 45 days prior to the end of the Assessment Period specified in the applicable BEA Program NOFA, all documents evidencing transactions that they wish to be considered Equity-Like Loans.

The purpose for this request is to enhance the Fund's ability to provide timely feedback to Applicants as to whether a transaction meets the Equity-Like Loan requirements prior to the end of the applicable Assessment Period. Such information will allow Applicants, if they so choose, to modify the instruments to conform to the requirements prior to the end of the Assessment Period. This process is intended to prevent circumstances in which an Applicant executes loan documents without review by the Fund only to learn near or after the close of the Assessment Period that the transaction is ineligible.

The Fund cannot guarantee timely feedback to Applicants that submit the aforementioned documentation less than 45 days prior to the end of the applicable Assessment Period.

Discussion and Sample Language:

The following section further discusses the Fund's required characteristics of Equity-Like Loans and provides some illustrative examples.

I. Minimum Term:

Requirement: The initial term of the loan must for a minimum of ten years at the time of origination.

Discussion: Equity Investments differ from debt instruments in that there is generally no mandatory time by which an investor will realize a dividend or be able to exit the investment. Generally, an investor places funds at-risk for an unspecified term. Most CDFIs have some need for long-term "patient" capital that does not require repayment in the near term, but instead can wait until the organization's activities can yield results. The Fund would like to encourage BEA Program Applicants to provide long-term, patient capital to CDFIs. The longer the term of a debt instrument, the more likely it can function in a manner similar to equity for the CDFI. Thus, the Fund requires that Equity-Like Loans be provided for a minimum, unconditional term of 10 years from the date of origination.

Sample Language:

"The principal balance of the Loan shall be due and payable ten (10) years from the date of the initial disbursement."

II. Maturity:

Requirement: The maturity date at the end of the initial ten year term must be a "soft" or indefinite, rolling maturity that is extended, subject to the following sentence, in no shorter than annual increments after the initial maturity date so long as the CDFI borrower continues to be financially sound and carry out a community development mission. The period of the extended rolling maturity must be a minimum of five years after the initial ten-year term. In other words, as long as the CDFI borrower remains fiscally sound and pursues a community development mission, the effective term of the loan must be at least 15 years.

<u>Discussion</u>: Generally, Equity Investments differ from debt instruments in that there is no mandatory time in which an investor will be able to exit the investment. The Fund will consider a loan to be an Equity-Like Loan if its maturity is “soft” for a minimum period of five years after the initial ten year term (meaning the maturity date is automatically extended at least annually by one additional year for at least five years following the initial ten year term) if the borrower continues to be financially sound and carry out its community development mission.

<u>Sample Language</u>:

Example 1:

“The principal balance of the Loan shall be due and payable ten (10) years from the date of the initial disbursement. At the end of the ten years, the Lender is obligated to extend the Loan’s maturity an additional year for a period of not less than five years if the Borrower continues to satisfactorily perform its obligations under this Agreement.”

Example 2:

“On ___ of each year commencing in ____ and terminating on ______ [insert a date not less than 10 years from the date of initial disbursement] (each such date, an Extension Determination Date), in the event that no Default is continuing, the Maturity hereof shall automatically be extended an additional year for a period of not less than five years. In the event that a Default has occurred and is continuing the Holder may, prior to the Extension Determination Date, inform the Maker of such Default and deliver written notice to the Maker of its intention not to extend that Maturity an additional year (a “Termination Notice”). If a Default as described in such Termination Notice is cured by the Maker in all material respects within ninety (90) days of receipt by the Maker of the Termination Notice, then that Maturity hereof shall automatically be extended for an additional year and the Termination Notice shall be of no effect. The failure of the Holder to so notify the Maker and/or declare such intention with respect to any particular Extension Determination Date shall not in any way be deemed to constitute a waiver of its rights to do so with respect to any determination as of a subsequent Extension Determination Date.

III. Repayment Terms:

<u>Requirement</u>: There shall be no periodic payments of principal during the initial term of the loan. However, the CDFI borrower may make periodic principal payments during the extended term of the loan or pay the entire loan off at maturity. Any payment of principal and/or interest on the loan (except at maturity) shall be required to be made only out of the borrower’s available cash flow after satisfying all other obligations, including all non-equity-like debt and operating expenses. Furthermore, failure to make payment of principal and/or interest shall not automatically result in a default. However, nothing in the foregoing shall be construed as a requirement to forego any right to any payment of principal or interest.

Discussion: An Equity Investment differs from a debt instrument in that there generally is no mandatory time frame in which an investee will pay a dividend to its investors and/or return the initial investment, in the absence of generated profits. In some cases, the investee may pay dividends on a regular basis, but in many cases it cannot. Failure on the part of the investee to pay, for example, a dividend on a regular schedule, generally does not give an equity investor the right to demand repayment of the investment principal. Accordingly, the Fund will consider a loan to be an Equity-Like Loan only if the debt instrument requires *no* periodic payments of principal during the initial term of the loan, and any payment made under the loan (including interest and/or principal, except at maturity) to the lender is contingent on the CDFI borrower's available cash flow (meaning the ability to pay after satisfying senior creditors/investors and operating expenses). Operating expenses are expenses incurred by the borrower in carrying out its regular course of business (e.g., salary, rent, utilities, professional fees, interest expenses for other creditors). Senior creditors shall be considered all creditors to which the CDFI borrower has outstanding obligations, except for creditors holding notes that are also determined to be Equity-Like Loans (i.e., ranking pari passu with the subject Equity-Like Loan). **It is not the Fund's intent to create a circumstance in which a borrower avoids payment altogether, but rather to be able to delay payment until it realizes positive cash flow.**

Sample Language:

"Unless the Holder finds an Event of Default on the part of the Maker, the Maker shall not be required to make any payment of principal and/or interest with respect to this Note when such payment is due if: (a) as a result of such payment, the Maker would be unable to make full payment of the principal amount and/or interest which is then due with respect to any outstanding obligations that are senior debt of the Maker; (b) as a result of such payment, the Maker would be unable to satisfy its operating expenses due at the time payment is due (or within ten business days of such due date); or (c) payment of this Note's principal amount and/or interest cannot be made from the Maker's available cash flow at the time payment is due. The Maker's requirement to make payments of interest to the Holder shall not be excused as a result of the occurrence of any of the above circumstances, but shall be required to be made on the first business day following the payment due date on which it has the available resources to make the interest payment in whole or part. In the event that any of the above circumstances prevents payment of the principal amount of the stated maturity date, the stated maturity date will be automatically extended by one year each year until the Maker has resources available for repayment subject to the same conditions described herein."

IV. Subordination:

Requirement: The loan must be subordinate to all other debt of the CDFI borrower except other Equity-Like Loans.

Discussion:

If an investee goes bankrupt, defaults on its obligations or otherwise ceases its business operations, the order in which its creditors have claims on its liquidated assets generally will depend on the seniority of the debt or equity instruments under which the creditors/investors provided resources to the investee. Generally, equity investors are junior to creditors in right of payment. An equity investor is therefore at greater risk of never recovering its principal if an investment goes bad. The Fund will require that Equity-Like Loans carry a higher degree of risk than other noncomparable debt instruments. Thus, to be considered an Equity-Like Loan, an investment must be subordinate to all other obligations of the CDFI borrower, except Equity-Like Loans.

Sample Language:

Example 1:

"Bank agrees that this debt shall be subordinated to all other creditors of the Borrower which are not under common control of Borrower, and shall rank pari passu as to time and right of payment with all other equity-like debt."

Example 2:

"The Equity-Like loan evidenced by this instrument will be subordinate to the right of payment of all other creditors of the Issuer."

Example 3:

"Notwithstanding any provision herein to the contrary, the indebtedness evidenced by this Note, including all interest hereon, is subordinate and junior in right of payment to all obligations of the Maker now outstanding or subsequently incurred, other than each obligation which, in the instrument creating or evidencing the same or pursuant to which the same is outstanding, provides that such obligation is not senior in right of payment to this Note."

Example 4:

"Notwithstanding any provisions herein to the contrary, the indebtedness evidenced by this Note, including all interest hereon, is subordinate and junior in right of payment to all Senior Debt obligations of the Borrower whether now or subsequently incurred. As Subordinated Debt, this note ranks pari passu with each other obligation, which, in the instrument creating or evidencing the same or pursuant to which the same is outstanding, provides that such obligation is subordinate in right of payment to Senior Debt, provided that such Subordinated Debt is equity-like."

V. Other Considerations

The Fund's overall goal for supporting the provision of Equity-Like Loans is to promote the flow of "patient", long-term, "stand alone" capital to CDFIs. Accordingly, while the four elements discussed above form the centerpiece of the Fund's determination of Equity-Like Loans, the Fund will consider additional factors. For example, the Fund will consider negative or other performance covenants contained in a promissory note. The Fund does not intend to interfere with the parties' right to negotiate commercially reasonable covenants, or dictate actions that trigger an event of default or the operation of default provisions (e.g., cessation of business operations, termination of existence, loss of good standing status, commencement of bankruptcy proceedings, assignment for the benefit of creditors or appointment of a receiver). However, the Fund will look closely at Equity-Like Loan documents to ensure that their provisions do not allow the holder to elevate itself to senior debt holder status through the operation of negative covenants and cross default or loosely drafted subrogation provisions.